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October 7, 2004

Ms. Marlene Dortch
Secretary
Federal Communications Commission
445 12th Street, SW, TW-A325
Washington, DC 20554

Re: Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, CC Docket Nos. 00-175, 01-337, and 02-33

Dear Ms. Dortch,

On October 6, representatives from BellSouth, SBC, Verizon and NERA met with Wireline Competition Bureau staff to discuss issues associated with the post-sunset accounting treatment of long distance services and the implementation of Sec. 272(e)(3). Specifically, the attendees representing the companies were: Mary Henze and Lyn Haney of BellSouth, Brett Kissel and David Cartwright of SBC, Joe DiBella and Tom Moynihan of Verizon, and William Taylor and Timothy Tardiff of NERA. WCB attendees were: Jane Jackson, Bill Dever, Michael Carowitz, Daryl Cooper, Kim Jackson, Bill Kehoe, Cliff Rand, and Jon Minkoff.

Discussion during the meeting focused on the "NERA Declaration" filed August 10, 2004 by BellSouth, SBC, and Verizon in the above referenced proceedings in response to the June 9, 2004 AT&T *ex parte* filing which contained a Declaration by Dr. Lee Selwyn. NERA representatives explained in detail how Dr. Selwyn's proposed post-sunset imputation is not only unnecessary but conflicts with the Commission's pro-competitive policies and sound economic practice. An outline of the discussion points is attached. In addition, the companies suggested that any post-sunset accounting issues should be resolved simply by adopting the Sec. 272(e)(3) implementation proposal first introduced into the record by BellSouth in November 2003. A summary of that proposal and its benefits is also attached.

This notice is being filed pursuant to Sec. 1.1206(b)(2) of the Commission's rules. If you have any questions regarding this filing please do not hesitate to contact me.

Sincerely,

Mary L. Henze

Mary L. Henze

Attachments

cc: J. Jackson
W. Dever
M. Carowitz
K. Jackson
D. Cooper
W. Kehoe
C. Rand
J. Minkoff

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	WCB Docket No. 02-112
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	CC Docket No. 00-175

Ex Parte Presentation

William E. Taylor, Timothy J. Tardiff, and Harold Ware,
National Economic Research Associates, Inc.,
On Behalf of BellSouth, SBC, and Verizon

October 6, 2004

I. SUMMARY OF CONCLUSIONS

- AT&T's proposal is:
- Unnecessary,
- Economically incorrect,
- Anticompetitive, costly, inefficient and harmful to consumers.

II. AT&T'S PROPOSAL IS UNNECESSARY.

A. Pervasive competition implies that ILEC facilities are not essential for provision of toll services.

- CLECs and IXCs bypass ILEC local access.
- Wireless providers compete for local and toll.
- Cable firms provide telephone services and broadband
- Broadband enables VoIP to bypass conventional wireline access.

B. Dr. Selwyn's proposal to classify ILEC long-distance service as dominant makes no economic sense.

- ILEC long-distance offerings are a small part of the total, which includes all platforms by which customers make long distance communications.
- Dr. Selwyn's market share analysis is fatally flawed because it:
  - Includes only the ILECs' residential customers;
  - Ignores intermodal competition; and
  - Ignores business customers.
- Long distance is far more competitive than when AT&T declared non-dominant.
- Declaring ILEC long distance services dominant would impose regulatory requirements that have no place in competitive markets.

C. Economic factors imply that BOCs have neither the incentive nor the ability to engage in anticompetitive pricing in long distance services.

- Competition implies that sacrificing profits by predatory pricing or a price squeeze cannot be profitable because:
  - Driving rivals from the market is unlikely; and
  - Recouping profits later is impossible.
- Price cap regulation means that misallocating costs to regulated services would not enable the BOCs to charge lower prices for competitive services.

III. AT&T'S PROPOSAL IS ECONOMICALLY INCORRECT.

A. The statutory imputation requirement should not be expanded to create *a priori* limits on price competition.

- Section 272(e)(3) imputation is a regulatory accounting safeguard, not a floor on pricing. It does not require before-the-fact price floors.

B. Price floors and imputation, if required, must be based on economic cost, not fully distributed accounting costs.

- A price squeeze test must be applied to an economically relevant set of services, i.e., to lines of business such as toll service as a whole. More granular application—e.g., for every service that has a separate price—would only hinder competition.
- Imputation is warranted only for essential inputs.

C. Dr. Selwyn's component-by-component price floors for bundled offerings are economically meaningless and would prevent ILECs from matching (or beating) prices that already prevail in the market.

- No economically meaningful way to assign separate prices to services included in a bundled service
- Proposal to calculate prices of individual services in a bundle based on stand-alone prices would harm consumers—e.g., finding the price of a bundle that includes intraLATA toll is "too low" because the $2 difference between bundles with and without intraLATA toll is less than the stand-alone price—would harm consumers by raising ILEC prices.

D. Dr. Selwyn's FDC cross subsidy test has been widely discredited for use in determining whether prices are anticompetitive.

- Reputable economists, including AT&T's own economic experts, have long argued that a service is cross subsidized only if it is priced below its own TSLRIC.
- The FCC itself recently stated: "... to avoid a cross-subsidy between two such services that are provided over a common facility, each service must recover at least its incremental cost, and neither service should recover more than its stand-alone cost."

IV. ADOPTING DR. SELWYN'S PROPOSAL ON BEHALF OF AT&T WOULD BE AN ANTICOMPETITIVE, COSTLY, INEFFICIENT, HARMFUL EXPANSION OF THE COMMISSION'S RULES

A. Dr. Selwyn's suggested changes to Part 64 allocation rules are costly as well as unnecessary.

- Dr. Selwyn's proposed "improvements" to Part 64 cost allocations would not fix the fundamental problems with allocated costs. Rather, they would:
  - Add new administrative complexity;

- Not provide relevant economic information for assessing a price squeeze
- Serve no useful regulatory purpose in today's price cap environment.
- Not change the fact that ILECs, like others in the market, use integrated management structures and integrated physical networks to provide a multiplicity of services.

B. The claim that economies of integration must "inure to the benefit of the BOC's local service" is bad law and bad economics.

- Economics, the law, FCC precedent and previous AT&T filings all agree that a cost-based pricing floor should use incremental cost, not FDC, as AT&T requests now.
- Assigning a "fair share" of common costs or "just and reasonable compensation" for benefits provided from one service to another have nothing to do with the economic standard for cross-subsidy.
- Contrary to Dr. Selwyn's claim, a reduction in the ILEC's LD incremental cost would immediately reduce its price floor, calculated correctly. Similarly, in competitive markets, LD cost reductions would result in price reductions for that service, not for local exchange services.
- Regulated customers can only benefit from scope economies if BOCs are allowed to compete based on their incremental costs.
- The proposed requirement to allocate all new investment costs to the new competitive service would protect AT&T from ILEC innovation.
- Costs shared between existing and new services should be recovered where market conditions permit, just as IXCs, cable and wireless companies recover their shared costs.
- Dr. Selwyn is incorrect when he claims that: (1) Sec 272(b) and (c) require cost accounting following 47 CFR 32.27, where the transfer price is the greater of fully distributed cost or fair market value; and (2) their purpose was to "facilitate realization of integration efficacies while assuring that the gains from such integration inure to benefit of the LEC's regulated services."
    - Congress clearly believed that Sec 272(b) and (c) should be of limited duration.
    - 47 CFR 32.27 does not require asymmetrical accounting for 272 affiliate transactions and it was never intended to apply to integrated services.
    - If purchasers of regulated services pay rates no higher than they otherwise would, they are not harmed by the firm's provision of unregulated services.
    - In contrast, Dr. Selwyn's rules would lead to excessive prices and restricted demand for unregulated services. Consumers would be harmed because such accounting would undermine the potentially immense consumer surplus gains that have come from new unregulated services—a classic case of killing the goose that lays the golden eggs.

C. Dr. Selwyn's "fair market value" approach is not consistent with the Telecom Act, and adopting it would harm consumers

- Dr. Selwyn confuses imputation with a "fair market value" concept that he would apply to selected BOC functions for use in setting price floors for toll and other services. This proposal introduces another unneeded, potentially costly requirement.
- The imputation standard of Sec. 272(e)(3) does not mention either "fair market value," or any functions besides network access.
- Estimating fair market value for other functions that are provided by a myriad of companies would be a costly waste of resources
  - The process would be difficult and contentious; and
  - Imputation is needed only for essential inputs, not for inputs, like billing and collection.

D. AT&T's proposed rules are anticompetitive.

- AT&T's proposal would prevent the BOCs from lowering prices to reflect their own incremental costs, while sheltering competitors under a pricing umbrella.
- Such a pricing umbrella would penalize consumers by impeding discounted bundled service offerings, and allowing business to be diverted from BOCs to other less-efficient firms.

V. CONCLUSION: ADOPTING THE BURDENSOME RULES PROPOSED BY DR. SELWYN ON BEHALF OF AT&T WOULD IMPEDE COMPETITION AND HARM CONSUMERS.

- AT&T, under the pretense of protecting competition, proposes onerous and unnecessary rules designed to protect itself from competition.
- With changing technology and converging markets, adopting the AT&T proposal would needlessly burden BOCs and regulators, at a time when such regulation should be reduced.
- Imposing these rules would cripple price competition for long distance services, thereby sacrificing the major source of consumer benefits stemming from the FCC's pro-competition policies of the past two decades.

Post 272 Sunset Implementation of 272(e)(3)

Introduction

Under current FCC requirements (96-150, Accounting Safeguards Order)

- BOC integrated incidental interLATA services are treated as non-regulated for accounting purposes and thus Part 64 allocation rules apply
- Implementation of Sec. 272(e)(3) access imputation requirement is accomplished through existing affiliate transaction rules

As BellSouth proposed in November 2003, FCC must modify rules so that after sunset of Sec. 272

- All BOC integrated interLATA services are treated as regulated for federal regulatory accounting purposes to avoid unnecessary cost allocation
- Implementation of Sec. 272(e)(3) access imputation requirement is accomplished by new rule

Sec. 272(e)(3) is the only post-sunset accounting safeguard required by the Act

Cost Allocation No Longer Valid or Necessary

In establishing original requirement for incidental interLATA services, Commission concluded non-regulated accounting treatment (and resulting Part 64 cost allocation) was necessary to "achieve greater accuracy" than that achieved under Part 36 and Part 69.

In same order, Commission noted "changes in the competitive condition of local telecommunications markets in the future may cause us to reexamine the continued need for our Part 64 cost allocation rules."

Since 1996, the local telecommunications market has become increasingly competitive and the FCC has responded with fundamental changes in interstate regulation and the role that costs play. These include:

- Price cap regulation combined with pricing flexibility has completely eliminated any link between ILECs' recorded costs and the prices they charge for services.
- Elimination of sharing and the low end formula adjustment mechanism (LFAM) which previously created potential incentives for price cap ILECs to shift costs
- Adoption of the CALLS plan under which rates are not based on the development and reporting of costs under any of the Commission's accounting and reporting rules.

Minimal role of costs in today's regulatory environment means "greater accuracy" of cost allocation is no longer necessary.

To avoid unnecessary burden, FCC must determine that integrated interLATA services should be treated as regulated for federal regulatory accounting purposes.

Cost allocation has no bearing on compliance with Sec. 272(e)(3), prevention of cross subsidies, or ratemaking and therefore is unnecessary.

Sec. 272(e)(3) Requirements - Background

Sec. 272 (e)(3) requires BOCs to charge themselves or their 272 affiliates the same price for access that they charge to unaffiliated entities.

In 1996 Accounting Safeguards Order, the FCC:

- Interpreted Sec. 272 (e)(3) "to require the BOCs to charge nondiscriminatory prices ... and to allocate properly the costs of exchange access" according to existing affiliate transactions rules.

- Specifically rejected proposals to use 272(e)(3) to "review the BOC Sec. 272 affiliates' prices, or profits, or both to ensure that the section 272 affiliates' prices cover their access charges and all other costs" because such a review would discourage BOCs from competing on price and would conflict with pro-competitive goals of 1996 Act.

- Determined no further rules were necessary to address predatory pricing by BOC 272 affiliates "because adequate mechanisms are available to address this potential problem" including Sections 201 and 202 and antitrust laws.

Since 1996, BOCs have met Sec. 272(e)(3) obligation by imputing access at the line-of-business level as required by FCC's affiliate transaction rules. Compliance has been audited under 272 Biennial Audit.

Sec. 272 (e)(3) Requirements – Post Sunset

The FCC's original findings regarding Sec. 272(e)(3) are even more valid today as wireline and intermodal competition in local, long distance, and bundled markets has increased. Therefore no dramatic change in Commission approach to implementing Sec. 272(e)(3) is necessary.

To help ensure that Sec. 272(e)(3) continues to be an effective safeguard in a post-272 sunset environment, FCC should adopt a new rule explicitly codifying the language of 272(e)(3), as well as providing accounting guidance.

The text of the rule would read as follows.

> ***53.102 Sec. 272(e)(3) requirements for interLATA activities***
> The Bell operating company shall charge the 272 affiliate or impute to itself when providing integrated interLATA service an amount for access to its telephone exchange service and exchange access that is no less than the amount charged to any unaffiliated interexchange carriers for such service. Such charges or imputation should be credited to the access revenue account and debited against interLATA revenue.

The appropriate accounts for this transaction are currently within Part 32.

- Part 32.5080 Network access revenue credited
- Part 32.5100 Long distance message revenue debited

Implementation of 272(e)(3) in this manner

- Makes implementation of 272(e)(3) explicit and independent of other rules that may be modified in the future.

- Existence of explicit rule facilitates FCC enforcement under its current authority and complaint processes. In addition, FCC could monitor compliance with new Part 53.102 by requiring BOCs to report the amount of charges and/or imputation to interLATA services in a new schedule in ARMIS Report 43-02.

- Ensures BOCs' interLATA service would be charged the exact same rate for access as other interexchange carriers. Ensures that the BOC LD service has same direct costs as the LD services offered by competitors.